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Keith Rake
Deputy Assistant Commissioner
The Bureau of the Public Debt
Department of the Treasury
P.O. Box 396
Parkersburg, WV 26101-0396

Re: Comments on Proposed Regulations Governing U.S. Treasury Securities--State and Local Government Series

Dear Deputy Assistant Commissioner Rake:

These comments on the notice of proposed rulemaking setting forth proposed revisions to 31 CFR Part 344 relating to U.S. Treasury Securities –State and Local Government Series ("SLGS") (69 FR 58756) (the "NPRM")are submitted on behalf of Orrick, Herrington & Sutcliffe LLP ("Orrick"). Orrick is a law firm with a large national practice in, among other things, municipal bond transactions. Our comments are focused upon several significant technical concerns we have with the NPRM that we believe can be resolved without frustrating the policy goals stated in the NPRM.

We have not specifically commented on the broad policy concerns implemented by the NPRM, namely that SLGS should not be used to provide cost-free financial options or to permit issuers to arbitrage the interplay between SLGS, whose yields are set on a daily basis, and open market Treasury securities, whose yields vary from moment to moment. We note, however, that these features of the NPRM will cause open market Treasury securities to be purchased in connection with tax exempt bond issues much more frequently than has been the case in the past few years, and the use of such securities in lieu of SLGS will result in administratively more complex transactions, increase the risk of tax law violations, increase the risk of errors in implementing transactions and eliminate for the Treasury the direct benefit of low yielding SLGS.[1]

[1] An example of why open market Treasury securities may be utilized where SLGS would have been favored in the past is as follows. Under current law, if there is negative arbitrage in an escrow, an issuer would not buy open market Treasury securities even if such an escrow would have less negative arbitrage, because the ability to do a future escrow restructuring with SLGS would provide an opportunity to reduce or eliminate the negative arbitrage. Under the NPRM, there will be a greater focus on eliminating negative arbitrage in the initial structure, which may be accomplished by open market Treasury securities. Further, an open market escrow restructuring may be the only opportunity to eliminate the negative arbitrage later.

1. **The requirement that a SLGS subscription may not be filed without issuer bond authorization should be deleted. Section 344.2(e)(2).**

Section 344.2(e)(2) of the Proposed Regulations requires that every subscriber for SLGS must certify that the issuer has "authorized the issuance of the state or local bonds." The Supplementary Information in the NPRM suggests that this new certification requirement is intended to prevent cancellations resulting from subscriptions by commercial banks and other institutions in cases in which such authorization has not occurred prior to the subscription.

We believe that this provision adds confusion and uncertainty to the subscription process and is neither necessary nor adequate to prevent the abuses it targets. It should be deleted.

The NPRM does not define what it means for an issuer to have "authorized the issuance" of refunding bonds, and given the extraordinary variety of state and local laws governing the bond issuance process, it is unlikely that Treasury could craft a definition that would reliably accomplish its objectives without precluding various types of issuers in individual jurisdictions from ever making use of the SLGS program. At one extreme, if the SLGS Regulations were to define bonds as "authorized" if and only if no further action by the governing body of the issuer were required to issue such bonds, the use of SLGS would not be possible in jurisdictions that permit a final bond resolution or declaration to be adopted only following confirmed sizing and pricing of the bonds, because sizing and pricing cannot be finalized without simultaneously finalizing the escrow structure.

In addition, the requirement, contained in Proposed Regulations Section 344.2(e)(1), that agents filing SLGS subscriptions certify they are acting under the issuer's specific authorization, should itself suffice to prevent the abuses targeted by Section 344.2(e)(2), because an issuer cannot authorize an agent to subscribe for SLGS on its behalf without simultaneously intending to issue the related bonds. As a result of the penalty for failure to complete a subscription, it would be useful for this subscription authorization to include a certification by the subscriber that the subscriber, and in cases in which there is a conduit borrower, the conduit borrower, is aware of the penalty that may be imposed for certain failures to complete a subscription.

If, however, it is thought necessary to retain this requirement, we urge you to define bond "authorization" in a manner that will provide clear and unambiguous guidance without inadvertently excluding broad categories of issuers from the universe of eligible purchasers. Treasury Regulations Section 1.150-2, which establishes the standards under which an issuer will be

treated as having expressed an intent to use bond proceeds to reimburse certain prior expenditures, offers a useful model. It should be sufficient for the SLGS Regulations to provide that bonds are "authorized" if the governing body of an issuer, or an official authorized to act on its behalf, expresses an intent to issue refunding bonds, even if such authorization is subject to typical contingencies, such as the attainment of adequate present value debt service savings. Any more specific requirement would prevent issuers from moving quickly to take advantage of short-term market fluctuations to achieve maximum debt service savings, given the notice periods for most public bodies to meet and act.

2. The requirement that SLGS may be purchased only with funds that constitute gross proceeds of an "issue" should be modified. Section 344.0(a).

Section 344.0(a) of the current Regulations permits SLGS to be purchased with any "amounts that constitute gross proceeds of an issue or any other amounts which assist an issuer of tax-exempt bonds in complying with applicable provisions of the Internal Revenue Code relating to such tax-exemption." Section 344.0(a) in the NPRM provides that SLGS may only be purchased with "amounts that constitute gross proceeds of an issue." The Supplementary Information in the NPRM offers no explanation for the modification of this section.

This narrowing of the universe of permissible fund sources for SLGS purchases to amounts that are gross proceeds as of the investment date would prevent certain legitimate uses of SLGS without furthering any of the policies described in the NPRM. We suggest that the proposed language in Section 344.0(a) be modified to provide that SLGS maybe purchased "from any amounts that constitute or are reasonably expected to constitute gross proceeds of an issue."

As drafted, this provision would prevent the purchase of SLGS with amounts that are not currently gross proceeds of an issue but that are expected to become such before their maturity. These situations may occur in a variety of circumstances, and the consequences of not being able to invest in SLGS may be severe, because investments in securities other than SLGS generally must be marked to market for federal tax purposes when they become allocated to an issue of tax-exempt bonds.

For instance, an issuer may issue taxable bonds to refund a tax-exempt issue that cannot be advance refunded, and then refund the taxable debt 3 months before the expiration date of the taxable escrow, at which point the investments in the escrow funded with proceeds of the taxable obligations will become gross proceeds of the tax-exempt refunding bonds and will be restricted to the yield on such bonds. Prior to the refunding of the taxable bonds, amounts in the escrow are not gross proceeds of any tax-exempt issue. If the issuer is unable to invest those amounts in SLGS and is forced, instead, to invest them in open market Treasury securities, those

securities will have to be marked to market when they become gross proceeds of the tax-exempt refunding issue; if interest rates have risen in the interim, the yield of the open market Treasury securities after the mark to market process will be higher than their original yield, and may well exceed the applicable federal tax yield limitation. It is essential that a SLGS investment be available.

To use another example, an issuer may want to invest amounts that are expected to be used to pay or secure the payment of debt service on a tax-exempt issue and that would be gross proceeds of a tax-exempt issue but for application of the universal cap rule contained in Treasury Regulations Section 1.148-6(b)(2), which provides that the value of certain categories of gross proceeds may not exceed the value of the outstanding bonds. The issuer may reasonably expect that these amounts will, over time, become gross proceeds of a tax-exempt issue as the bar of the universal cap is lifted. The SLGS Regulations should permit investment of these amounts in SLGS, even though they are not gross proceeds as of the delivery date

3. **The reduction in the hours during which an issuer may file SLGS subscriptions will create unnecessary hardship for issuers in Hawaii, Alaska and the west coast and should be modified to permit subscriptions until 10:00 p.m., Eastern time. Section 344.3(g).**

Section 344.3(g) establishes a 6:00 p.m. Eastern time deadline for submissions of SLGS subscriptions and requests for redemption of SLGS, which can correspond to 3:00 p.m. on the west coast, 2:00 p.m. in Alaska, and noon in Hawaii. While these hours may normally be sufficient for issuers on the east coast and the midwest, they would disrupt traditional practices in the west. In addition, reducing the hours during which SLGS subscriptions may be filed would cause timing problems in complex transactions on the east coast as well.

A variety of tasks must be performed on the day on which bonds are sold before a SLGS subscription can be filed. Even in the simplest cases, negotiation of the final details of pricing and verification may not be completed before noon in Hawaii or 3:00 p.m. on the west coast. In more complex transactions involving multiple refundings, complex transferred proceeds penalty calculations, and escrows to be funded with a mixture of SLGS and open market Treasury securities, it may be after 6:00 p.m. even on the east coast before an issuer is in a position to file a SLGS subscription.

These timing constraints are less burdensome in the case of early redemptions of Time Deposit securities and Demand Deposit securities, although verifying complex escrow restructurings would also put west coast, Alaskan and Hawaiian issuers under significant time constraints, and we recommend that the deadline be pushed back from 6:00 p.m. to 10:00 p.m., Eastern Time, in all cases.

4. **Purchasers should be given some flexibility to defer the issue date of SLGS to deal with unanticipated problems causing a delay in bond closing. Sections 344.5(a), 344.5(d)(1) and 344.8(a).**

Section 344.3(b)(3)(i) of the current Regulations permits amendment of a subscription to permit SLGS to be delivered up to 7 days after the original delivery date. Sections 344.5(a) and 344.8(a) of the NPRM eliminate this flexibility, and Section 344.2(h) imposes a 6 month penalty for failure to take delivery unless a waiver is granted under Section 344.2(h)(2).

It is occasionally impossible for an issuer to close a bond transaction on the originally scheduled date, due to a variety of circumstances outside its control. While such delays may not often happen, they do happen with some regularity, particularly in the case of privately placed debt.

We understand that Treasury believes subscribers have employed the existing 7 day rule to increase their ability to realize value from the cost free option implicit in Time Deposit securities. We believe, however, that other provisions of the NPRM already eliminate the possibility of such practices continuing. Under the NPRM, in cases in which SLGS are purchased in connection with the delivery of a bond issue, they will, in the case of fixed rate issues, almost always be subscribed for on the date on which the bonds are sold. While a 7-day period is not necessary to deal with such situations, a 3 business day period would be extremely useful. The effect of such a delay on Treasury's cash balance forecasting would be minimal or non-existent, given the infrequency of such delays.

We urge you to modify Section 344.2(h) to provide that The Bureau of the Public Debt (the "Bureau") will automatically waive the 6 month penalty if the actual settlement date is no more than 3 business days after the original delivery date and to modify Section 344.5(d)(1) to provide that the delivery date may be changed to permit delivery up to 3 business days after the originally specified delivery date.

5. **The Proposed Regulations could be read to prohibit non-governmental issuers of tax-exempt bonds from purchasing SLGS and should be modified to include such issuers as eligible subscribers. Sections 344.0(a) and 344.1.**

Under Revenue Ruling 63-20 and Revenue Procedure 82-26, certain non-profit organizations may issue tax-exempt obligations on behalf of a governmental body.

Section 344.0(a) of the NPRM provides that the SLGS are offered to "issuers," and Section 344.1 defines an "issuer" to mean the government body that issues state or local governmental bonds." These provisions could be interpreted to preclude non-profit issuers of tax-

exempt 63-20 bonds from participating in the SLGS program, even though such non-profits are expressly permitted by Section 4 of Revenue Procedure 82-26 to issue tax-exempt advance refunding bonds in certain cases. Although a government body must approve all such issuances, it is not clear whether the approving governmental body would be treated as the "issuer" under the provisions of the NPRM and, if so, whether the non-profit would need specific authorization from the governmental body to subscribe.

This problem does not arise under the current SLGS Regulations, because Section 344.0(b) of such Regulations defines a "government body" to include all issuers (whether or not truly governmental) of state or local government bonds described in Section 103 of the Internal Revenue Code.

We assume this result was unintended and recommend that the definition of "Issuer" in Section 344.1 be amended to include "the Government body or other entity that issues state or local government bonds described in section 103 of the Internal Revenue Code."

6. **Sections 344.2(e)(3)(i) and 344.2(f)(1)(ii) and (iii) should be amended to permit the yield to yield comparison required in the case of purchases of SLGS with amounts received from sale or redemption of SLGS or open market Treasury securities to be made on an aggregate basis rather than on an individual security basis. Sections 344.2(e)(3)(i), 344.2(f)(1)(ii), 344.2(f)(1)(iii).**

Sections 344.2(e)(3)(i) (A) and (B) require a yield to yield comparison of a SLGS to be purchased with proceeds of sale or early redemption of a Time Deposit security or an open market Treasury security. These sections require such a comparison to be made on a security by security basis, and assume that for each security sold, there will be one and only one security purchased. The restructuring of an escrow to eliminate inefficiencies will generally require sale of a number of securities, whether SLGS or open market Treasury securities, and their replacement by a number of new securities. The new securities may not mirror the old, and there is no effective way to comply with the current version of these sections without first identifying which SLGS, or which portion of a SLGS, is being purchased with amounts received from sale or redemption of a particular old escrow security. A single open market Treasury security, for instance, may be replaced with a number of SLGS, some with yields that exceed the yield on the old security, others with yields less than the yield on the old security. It is important that issuers be permitted to make the necessary certifications by comparing the yield on the aggregate portfolio sold or redeemed and the yield on the aggregate SLGS portfolio being purchased.

If this amendment is made, collateral amendments would need to be made to 344.2(e) and 344.2(f) to reflect the shift from a comparison of the yields on individual securities to a comparison of portfolio yields.

We would note that a yield comparison performed on a security by security basis may not effectively prohibit an issuer from subscribing for new SLGS at yields that will result in an increased yield on an escrow: if the old SLGS has a yield in excess of the yield of the entire escrow, an issuer can satisfy the yield certification and yet increase the overall escrow yield by extending the maturity of the new SLGS.

7. **Section 344.2(e)(3)(i)(B) should be amended to permit issuers who purchase SLGS with the proceeds of SLGS redeemed prior to maturity to actually do so at a yield equal to the yield used to determine the amount of redemption proceeds for the redeemed Time Deposit securities. Section 344.2(e)(3)(i)(B) and 344.2(f)(1)(iii).**

Section 344.2(e)(3)(i)(B) requires an issuer subscribing for a SLGS with proceeds derived from the early redemption of another SLGS to certify that the yield on the new SLGS does not exceed the yield used to determine the amount of redemption proceeds for the redeemed SLGS, i.e., the Treasury borrowing rate over the remaining term to maturity. However, it is meaningless to permit acquisition of new SLGS at such a yield when no such yield will ever be available unless the new SLGS has a longer maturity than the redeemed SLGS, because SLGS rates are set at the Treasury borrowing rate less 5 basis points. This loss is particularly onerous given that the only permitted purpose for escrow restructuring under the NPRM is to eliminate escrow inefficiencies, and the savings derived from such transactions will invariably be small, while the transaction costs will not differ from those incurred in connection with restructurings under the existing SLGS Regulations. This problem could be fixed by amending Appendix B to Part 344 to provide that, in cases in which proceeds from an early redemption of SLGS are to be used to acquire other SLGS, the discount rate to be used to determine the amount of redemption proceeds will equal the current Treasury borrowing rate less 5 basis points.

8. **Section 344.5(a) should be amended to permit subscription for 0% Time Deposit securities on the date on which the initial Time Deposit securities for a refunding or defeasance escrow are subscribed for, rather than the period beginning 60 days before their issuance. In the case of 0% Time Deposit securities to be used in connection with an escrow initially funded with marketable securities, Section 344.5(a) should be amended to permit subscription for 0% Time Deposit securities to be used in connection with an**

escrow of marketable securities on or after the date on which the issuer contacts to purchase such marketable securities. Section 344.5(a).

Refunding and defeasance escrows are frequently structured with 0% SLGS to invest proceeds from the maturity of SLGS or open market Treasury securities in the interval between their maturity and an escrow payment date in a manner that will assist the issuer in complying with applicable federal tax yield limitations. In the last two years, the Internal Revenue Service has publicly disclosed that escrow agents have, as a result of administrative oversight, frequently failed to subscribe for such 0% SLGS in timely fashion; the Service has suggested that it believes these failures have occurred in thousands of cases.

The causes of such failures are easy to understand; we suspect that they relate almost exclusively to the difficulty of retaining easily accessible lists of required reinvestments, which can occur years after the creation of the escrow, particularly in an industry that has historically witnessed a high level of corporate acquisitions and divestitures. The SLGS program should be modified to permit subscription for such securities at the same time the refunding or defeasance escrow is originally established. This will allow the 0% SLGS investment to be locked in place and reduce the possibility of administrative errors, and given the fact that the concept of a cost free financial option has no meaning when it comes to 0% SLGS, a special rule should be adopted permitting such cancellation.

In the case of 0% SLGS to be purchased with proceeds of maturing SLGS, the Bureau could permit payment by an automatic allocation of a portion of the proceeds received from the maturity of the maturing SLGS and allocate the amounts received to the purchase or redemption of other U.S. Treasury securities; such targeting should eliminate concerns about possible debt limitation bars on the issuance of such 0% SLGS. In the case of 0% SLGS to be purchased with the proceeds of maturing open market Treasury securities, which would be the most common case, the Bureau would need to create a mechanism that would permit it to debit the appropriate trustee account and to modify such account numbers if the identity of the trustee or the number of the account changed in the interval between subscription and delivery. Amounts received from such purchases could also be allocated to the acquisition of other U.S. Treasury securities, to alleviate debt limitation concerns.

9. **Section 344.2(m)(4) should be amended to clarify that Treasury will not revoke an issuance of SLGS as a result of an impermissible transaction under Section 344.2(f) if the reason for such an impermissible transaction is an inadvertent error. Section 344.2(m)(4).**

Section 344.2(m)(4) permits Treasury to revoke any issuance of SLGS if (1) the SLGS was issued on the basis of an "impermissible certification or other misrepresentation and (2) the impermissible certification or other misrepresentation was not the result of an "inadvertent error." However, the same section provides that any issuance of SLGS may be revoked if there is an "impermissible transaction" under Section 344.2(f), even if an inadvertent error was the cause of such impermissible transaction. Sections 344.2(f)(1)(ii) and (iii) include, as "impermissible transactions," subscriptions for SLGS at yields higher than the redemption yields of SLGS or marketable securities redeemed or sold prior to maturity. Sections 344.2(e)(3)(i) (A) and (B) require that a subscriber certify that the yield to yield requirements are not being violated. It would be anachronistic to provide that a SLGS issuance could not be revoked if a certification were made incorrectly, but inadvertently, and yet cancel the issuance because the transaction itself was impermissible. Given the difficulties of calculating yield on securities in complex situations, there will be instances in which a certification is false, and an impermissible transaction is entered into, because of an inadvertent error in calculating and performing the necessary yield comparison, and the ability of a verifier or bond counsel to conclude that a SLGS escrow satisfies the defeasance provisions of an applicable indenture may be adversely affected if an unintentional error in a complex financial calculation can result in Treasury being able to cancel an issuance.

10. Section 344.5(e)(1) should be amended to clarify that the official that completes a SLGS subscription need not be the official occupying the position identified on the commencement of SLGS subscription process as required by Section 344.5(b)(4). Section 344.5(e)(1).

As with the current Regulations, Section 344.5(e)(1) of the NPRM requires that the finalization of a SLGS subscription must be submitted by an "official authorized to make the purchase." Unlike the current Regulations, Section 344.5(b)(1) requires that the equivalent of the current initial subscription must state "the title of an official authorized to purchase SLGS securities." Section 344.2(b)(1) does not require the identification of all officials authorized to purchase SLGS, but it is important to eliminate any implication that the person completing a subscription must be the person occupying the office identified at the commencement of the subscription process; otherwise, the temporary unavailability of an official through illness, vacation or press of business could unnecessarily impede the finalization of a subscription and the issuance of SLGS.

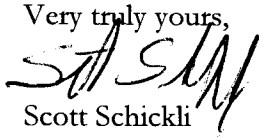
11. If SLGSafe is to be the only means of subscribing for and redeeming SLGS, it is imperative that certain existing technical problems with SLGSafe be resolved before finalization of the Regulations.

We are aware of two technical problems with the SLGSafe program that should be fixed before use of SLGSafe is made mandatory.

First, we understand that SLGSafe is currently structured in a manner that precludes its use by anyone except issuers and banks, and yet the existing SLGS Regulations, as well as the NPRM, explicitly permit agents other than banks to act on behalf of issuers in subscribing for and redeeming SLGS. Within the last year, we were informed by personnel at the Bureau of Public Debt that SLGSafe operates at the bank omnibus level, and not at the individual account level, so that a bank with a SLGSafe authorization has access, through that single master level authorization, to all SLGS accounts for all escrows for which it is escrow agent or trustee. As a result, we understand that there is no way to permit non-banks access to SLGSafe for a particular transaction involving a particular trustee or escrow agent without simultaneously giving them access to all other SLGS accounts for which the bank served as trustee or escrow agent, and that non-banks are, as a result, currently precluded from using SLGSafe as a result of the need to preserve confidentiality. If non-banks are to be permitted to subscribe and redeem SLGS, and SLGSafe is to be the only means of subscription and redemption, it is imperative that this problem be fixed, if it has not been done already.

Second, we understand that several financial institutions have been unable to participate in SLGSafe due to technical problems relating to the required use, by Treasury, of a particular sort of digital signature that is incompatible with the banks' firewall and other internet security systems. These problems also need to be fixed before SLGSafe is made mandatory. We understand that the Final Interim Rule, effective on August 11, 2004 (Federal Register, 69 FR 41756) was intended to address these concerns, but we urge the Bureau, if it has not already done so, to confirm that the problem on longer exists.

Very truly yours,



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